

**BEFORE THE
COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

Investigation by the Department of Telecommunications
and Energy on its own Motion into the Appropriate Pricing,
based upon Total Element Long-Run Incremental Costs,
for Unbundled Network Elements and Combinations
of Unbundled Network Elements, and the Appropriate
Avoided Cost Discount for Verizon New England, Inc.
d/b/a Verizon Massachusetts' Resale Services
in the Commonwealth of Massachusetts

D.T.E. 01-20

**REPLY BRIEF
of
THE UNITED STATES DEPARTMENT OF DEFENSE AND
ALL OTHER FEDERAL EXECUTIVE AGENCIES**

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**POST–HEARING REPLY BRIEF
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I. INTRODUCTION

The United States Department of Defense and All Other Federal Executive Agencies (“FEAs”) participated in this proceeding because their activities require a wide array of telecommunications services and facilities provided by Verizon and competitive local exchange carriers (“LECs”). As large end users, the FEAs are vitally concerned with Verizon’s charges for unbundled network elements (“UNEs”). Indeed, the charges established in this case will play an important part in determining whether FEAs and other end users can receive the benefits of more competition for local telecommunications services in Massachusetts.

The FEAs filed Rebuttal Testimony to address submissions on UNE costs and charges by Verizon and AT&T Communications (“AT&T”).¹ Also, the FEAs provided Surrebuttal Testimony to address UNE cost and rate issues.² On March 5, 2002, the FEAs submitted an Initial Post–Hearing Brief to summarize their positions and recommendations for the Department. Throughout, the FEAs urged the Department to take actions requiring Verizon to employ cost–based charges for UNEs in order to foster more competition for telecommunications services. In their brief, the FEAs explained that:

- The Department should rely substantially on modeling approaches used by Verizon’s competitors because they provide a better representation of future costs.³
- Verizon’s proposal to employ a “market–based” capital structure should be rejected because it does not conform with the costs that Verizon will incur when the rates at issue are effective.⁴
- Verizon’s UNE charges should reflect all savings from the merger with GTE.⁵
- The Department should prescribe UNE charges that fully recognize Verizon’s lesser costs when services are provided to carriers on a wholesale basis.⁶
- All carriers should have efficient access to facilities in multi–floor buildings, with Verizon’s charges set at cost–based rates.⁷

In Verizon’s brief submitted on March 5, 2002, the only reference to an FEA position concerns capital structure, the second issue listed above. Thus, to minimize additions to

¹ Rebuttal Testimony of Harry Gildea , July 16, 2001 (Ex. DOD–1).

² Surrebuttal Testimony of Harry Gildea, December 17, 2001 (Ex. DOD–2).

³ Initial Post–Hearing Brief of the FEAs, pp. 2–6.

⁴ *Id.*, pp. 6–10.

⁵ *Id.*, pp. 10–11.

⁶ *Id.*, pp. 11–14.

⁷ *Id.*, pp. 15–18.

the voluminous record, the FEAs will only address Verizon's comments on this issue in this Post-Hearing Reply Brief.

II. CONTRARY TO VERIZON'S CLAIMS, "REGULATORY RISK" DOES NOT JUSTIFY USE OF A "MARKET-BASED" CAPITAL STRUCTURE.

Verizon's capital structure — the relative proportions of debt and equity employed to determine the company's cost of capital — is an important parameter in determining UNE costs. On this subject, Verizon's witness asks the Department to adopt a "target market value capital structure" containing 25 percent debt and 75 percent equity as the basis for the weighted average cost of capital.⁸ In rebuttal, the FEAs explained that this structure will not represent the company's capital requirements for the period when the charges being set in this case are effective.⁹

The FEAs urged the Department to reject the "market value" approach and consider the company's actual capital requirements.¹⁰ Considering the capital structure on the company's books, the FEAs asked the Department to prescribe a capital structure of 40 percent debt and 60 percent equity as a very conservative basis for determining the charges for UNEs.¹¹

In its post-hearing brief, Verizon asserts that the FEAs' proposal does not account for the high "regulatory risk" that the company faces in providing UNEs.¹² However, the FEAs urge the Department not to heed this claim.

The FEAs explained that Verizon's accounting records support a capital structure consisting of 55 percent debt and 45 percent equity because the company's annual report shows long term debt of \$42.5 billion and stockholders' equity of \$34.6 billion at the end

⁸ Direct Testimony of James H. Vander Weide (Exh. VZ-3), p. 48.

⁹ Initial Post-Hearing Brief of the FEAs, p. 6.

¹⁰ *Id.*, p. 9.

¹¹ *Id.*, pp. 9–10.

¹² Initial Post-Hearing Brief of Verizon, p. 37 and p. 39.

2000.¹³ These figures are consolidated totals for the company's operations in four business segments — Domestic Telecommunications, Domestic Wireless, International, and Information Services.¹⁴ Moreover, as FEAs noted:

Among Verizon's four business segments, the segment called Domestic Telecommunications, which contains the activities at issue in this proceeding, is the most regulated, least competitive and least "risky" of all. Thus, if the segments were separately financed, the Domestic Telecom segment would have a greater debt-to-equity ratio than for all four segments combined on a consolidated basis. A debt ratio of 25 percent, as hypothesized by Verizon, is simply not consistent with the financial requirements for UNEs being established in this case.¹⁵

In summary, the FEAs explained that there is no reason to conclude that Verizon's services at issue in this case have a risk level that supports a capital structure with less debt than the total for all of the company's operations combined.

Indeed, the principles enunciated in the Telecommunications Act of 1996, and the requirement that UNE prices be set at Total Element Long-Run Incremental Costs ("TELRIC") reduce Verizon's risks in providing UNEs relative to the risks incurred in offering unregulated telecommunications services. Regulation mandating pricing at TELRIC also protects Verizon. A paper authored by two of Verizon's witnesses in this case describes the protection that Verizon receives. The paper explains that implicit in the TELRIC methodology "are the assumption that (1) the incumbent LEC will effectively be a monopolist in the provision of network elements for the indefinite future and (2) competitors will need to obtain such elements to compete over this time frame."¹⁶

¹³ Initial Post-Hearing Brief of the FEAs, p. 7, citing Verizon Communications Annual Report for 2000, p. 33.

¹⁴ Initial Post-Hearing Brief of the FEAs, p. 10.

¹⁵ *Id.*, p. 7, citing Exh. DOD-1, p. 9.

¹⁶ AT&T's Initial Post-Hearing Brief, p. 20, citing Exh. ATT-3, Attachment JH-12 and Timothy Tardiff, William Taylor, Charles Zarkada, and Jamie d'Almeida, *An Economic Evaluation of Network Cost Models*, Appendix A, p. 4, published by the National Economic research Associates, Cambridge, Massachusetts, August 7, 2000.

For unregulated services without a TELRIC obligation, Verizon may construct extensive facilities in hopes of substantial profits, but later find that there is insufficient demand to recover the funds expended. On the other hand, for UNEs priced properly at TELRIC, Verizon covers its incremental costs and is assured of a reasonable return.

Verizon is protected in an additional way. The company can petition for changes in UNE rates if circumstances warrant, a fact noted by the New York Public Service Commission in addressing the impact of risks borne by the company on its capital requirements.¹⁷

In summary, UNE pricing at TELRIC provides Verizon with a substantial assured market at profitable rates. Thus, contrary to Verizon's claims, the Department should find that there is no unusual "regulatory risk" that justifies departure from a capital structure of 40 percent debt and 60 percent equity for the purpose of determining Verizon's charges for UNEs in this proceeding.

¹⁷ New York Public Service Commission, Case No. 98-C-1357, Order on Unbundled Network Element Rates, January 28, 2002, p. 87.

III. CONCLUSION

WHEREFORE, the premises considered, the U.S. Department of Defense and All Other Federal Executive Agencies urge the Department to adopt the recommendations set forth in this Post–Hearing Reply Brief.

Respectfully submitted,

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